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Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules

Docket No. R-1603 and RIN 7100-AF 02

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Please find below comments to some of the Questions the Board presented. The comments are limited to financial instruments and credit risk mitigation. The proposed amendments:

- *will impact the fixed income preferred stock market*
- *reintroduce the topic of contingent capital instruments and;*
- *provide an enhanced rationale to undertake credit risk mitigation*

Overall, the Board's proposed amendments provide incremental transparency to stakeholders thereby enabling a more realistic and improved allocation of capital amongst the varying type of Firms.

Question 2: For example, should the Board consider scaling the stress capital buffer requirement by the ratio of a firm's standardized total risk-weighted assets to its advanced approaches total risk-weighted assets in cases where the firm's advanced approaches capital ratio calculations are lower than its standardized capital ratio calculations? What are the advantages or disadvantages of such an approach?

> *Scaling is sensible as the two ratios are theoretically linked to converge during times of stress. The Board stated "*the supervisory stress test and the advanced approaches are calibrated to reflect tail-risks; thus it could be duplicative to require a firm to meet the requirements of the advanced approaches on a post-stress basis.". Scaling of the actual severely adverse SCB tethers the two capital ratios during actual times of stress to minimize any discrepancy between actual and projected capital requirements.

Question 5: How should the Board contemplate the appropriate level of the countercyclical capital buffer in light of the proposal?

The CCB should be included in the SCB. The CCB is simply a reflection of an increase in the severity of the stress test. Implementation of the CCB through changes in stress test severity will enable implementation differentiation amongst Firms. Firms that retain or build capital as a proxy for a CCB will be well positioned for effective CCB implementation through the SCB. Firms that do not adjust their balance sheet to take account of circumstances that warrant a CCB will have an incrementally more severe successive SCB.

The rationale for having a CCB is based on actual and expected economic circumstances. The SCB is based on projected economic circumstances. As much as the SCB is said to be an overall projection and not a forecast; this is time varying. At some times the SCB may implicitly include a CCB, which is based on actual and expected economic circumstances. This is a function of how much of the SCB is a forecast or projection.

There is a simplicity to retain the concept of the CCB through the SCB. However, doing so will necessitate the Board to further reiterate the SCB severely adverse stress scenario takes account of actual, expected and projected conditions the results of which are not individually discernable.

Additionally, in December 2017, the Board released a package of proposals that would increase the transparency of the supervisory stress test. The package included three proposals for public comment: (1)…., (2)…, (3) an amendment to the Board's Policy Statement on the Scenario Design Framework for Stress Testing (Scenario Design Policy Statement) *that would make the scenario development process more countercyclical.*

These expected enhancements further support a CCB being a non-discernable component of the SCB

Question 7: Besides stated payments on regulatory capital instruments and issuance of common or preferred stock associated with a merger or acquisition, what, if any, other types of planned capital actions should the Board incorporate into the supervisory stress test for the purposes of calculating the stress buffer requirements, and why?

The Board recently considered contingent capital instruments within the context of determining the eligibility of TLAC bail-in instruments; Regulations YY; Docket No. R-1523 RIN 7100-AE37,

and some time ago considered contingent capital instruments in response to:

- **REPORT TO CONGRESS ON STUDY OF A CONTINGENT CAPITAL REQUIREMENT FOR CERTAIN NONBANK FINANCIAL COMPANIES AND BANK HOLDING COMPANIES**

FINANCIAL STABILITY OVERSIGHT COUNCIL

Completed pursuant to Section 115(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act July 2012

- IV. Conclusions

  "The issuance of contingent capital instruments could provide a useful tool for strengthening financial institutions' capital positions and ability to withstand losses during times of financial stress. Contingent capital issuances have the potential to provide these benefits at a lower cost of capital than additional common equity issuances, although contingent capital instruments are generally not as loss absorbing as common equity. The United States experience with instruments similar to contingent capital is quite limited and, as discussed above, there are a range of potential issues that could be associated with contingent capital instruments, depending on their structure and, in particular, the structure and timing of conversion triggers.

  Therefore, at this time, the Council recommends that contingent capital instruments remain an area for continued private sector innovation. ***The Council encourages the Federal Reserve and other financial regulators to continue to study the advantages and disadvantages of including contingent capital and bail-in instruments in their regulatory capital frameworks.***"

Amending the capital rule to include the SCB will require Firms to undertake heightened capital management actions. Management of the SCB is more volatile during deteriorating market conditions. As the Board itself has stated, Firms may not have market access nor the ability to eliminate scheduled alternative tier 1 preferred stock dividend payments.

  - "Hence, even if the outlook for a publicly traded firm has significantly worsened, public pressure and competition may deter the firm from reducing dividend payments."

  - "As in the current supervisory post-stress capital assessment, the Board would continue to assume in the supervisory stress test that a firm would make payments on any instrument that qualifies as additional tier 1 capital or tier 2 capital equal to the stated dividend, or contractual interest or principal due on such instrument during the quarter.

Based on supervisory experience, reductions in these payments are generally viewed by market participants as a sign of material weakness and firms are therefore likely to make them even under stressful conditions.

The FR- Y 14 enables planned capital actions at a time certain in future to be reported as other than issuances of regulatory capital instruments.

> "The Board would also generally assume in the supervisory stress test that a firm does not make any planned issuance of regulatory capital instruments, parallel to the assumption that a firm does not repurchase any regulatory capital instruments."

These time certain mandatorily convertible regulatory capital instruments *are not issuances and are planned to convert at a time certain in future.*

Non-mandatory contingent regulatory capital instruments are not convertible at a known time certain in future. These instruments are convertible from one form of regulatory capital instrument to another form of regulatory capital instrument such as common equity tier 1. The time of conversion is linked to regulatory capital ratios such as the SCB as reported pursuant to Question 25.

Further amending the FR -Y 14 to report both projected and planned time certain contingent regulatory capital instruments will enable Firms during deteriorating market conditions to manage available capital resources to cover the SCB.

Question 8: What are the advantages and disadvantages of including or excluding dividend payouts and certain other planned capital actions in the calculation of the stress buffer requirements when considered in combination with other elements of the proposal or alternatives to the proposal?

For instance, under the proposal, within two business days of receipt of initial notice of its stress buffer requirements, a Firm would be required to assess whether its planned capital distributions are consistent with the effective capital distribution limitations that would apply on a pro forma basis under the BHC baseline scenario throughout the fourth through seventh quarters of the planning horizon.

In the event of an inconsistency, a firm would be required to reduce the capital distributions in its capital plan to be consistent with such limitations for those quarters of the planning horizon. A firm would be required to notify the Board of any reductions in capital distributions in its capital plan.

This Question 8 will enable some flexibility to Section 252.44. Section 252.44 is amended by adding paragraph (c). The addition reads as follows:

"(B) The covered company will make payments on instruments that qualify as additional tier 1 capital or tier 2 capital equal to the stated dividend, interest, or principal due on such instrument";

Having some flexibility to adjust additional tier 1 and tier 2 capital payments recognizes the full discretion a Firm may have to eliminate scheduled payments through either cancelation or contingent conversion to common equity tier 1.

Question 23: What, if any, other changes to CCAR or the capital plan rule should the Board consider? For example, what advantages or disadvantages would be associated with:

1. *Providing additional flexibility for a firm to exceed capital distributions included in its capital plan if its earnings and capital ratios are above those in its BHC baseline;*

   Section 252.44 is amended by adding paragraph (c). The addition reads as follows:

   - "(B) The covered company will make payments on instruments that qualify as additional tier 1 capital or tier 2 capital equal to the stated dividend, interest, or principal due on such instrument";

   Above Question 7 Comments outlined the possibility for a Firm to have contingent capital instruments convertible from additional tier 1 or tier 2 into common equity tier 1. The covered company will make payments on instruments that qualify as additional tier 1 capital or tier 2 capital equal to the stated dividend, interest. To the extent these instruments are projected to have converted to common equity tier 1 the covered company will not pay any dividends on any instruments that qualify as common equity tier 1 capital. Having the *additional flexibility for a Firm to exceed the capital distributions included in its capital plan if its earnings and capital ratios are above those in its BHC baseline will enable* contingent capital instruments that in fact remain outstanding in the form of additional tier 1 and tier 2 to continue to make payments on these instruments equal to the stated dividend, or interest.

   This will enable for capital planning with the flexibility of actual fact and circumstances.

Further, having a transparent capital plan that offers clarity and timely financial flexibility enables a Firm to continue to issue these types of capital instruments during deteriorating market conditions.

2. The Proposed SCB provides Firms with additional incentive to take actions to manage or mitigate forward-looking credit risk. The Board from time to time has provided the public with views as to risk transfer such as:

- SR 13-23: Risk Transfer Considerations When Assessing Capital Adequacy – Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions (SR letter 12-17/CA letter 12-14)

The Capital Assessments and Stress Testing information collection consists of the FR Y-14A, FR Y-14Q, and FR Y-14M reports. The semi-annual FR Y-14A collects quantitative projections of balance sheet, income, losses, and capital across a range of macroeconomic scenarios and qualitative information on methodologies used to develop internal projections of capital across scenarios.

The Instructions, https://www.federalreserve.gov/publications/2018-february-comprehensive-capital-analysis-and-review-summary-instructions.htm to these reports with respect to "Estimates of Projected Revenues, Losses, Reserves, and Pro Forma Capital Levels" states a Firm should clearly identify and report to the Federal Reserve any aspects of its portfolios and exposures **that are not adequately captured in the FR Y-14 schedules** and that the firm believes are material to loss estimates for its portfolios.

- **Some examples may include portfolios that have contractual loss-mitigation arrangements**

The proposal would modify the FR Y-14 reports in order to collect information regarding a firm's capital conservation buffer requirements (including the stress buffer requirements) and any applicable distribution limitations under the regulatory capital rule.

The FR Y-14 is a reporting tool for Firms to manage SCB capital requirements. Credit risk mitigation reporting modifications will further enable Firms to manage SCB capital requirements. Systematically improving the standardized reporting of these credit risk mitigation transactions provides more clarity to the Company Run and Board stress test results.

The FR Y-14 modifications should be expanded to systematically capture credit risk mitigation transactions. This will enable Firms to more transparently report the impact these transactions have on reported exposures during severely adverse scenarios

Question 25: The proposal would require all firms subject to the stress buffer requirements to report their eligible retained income and capital distributions and discretionary bonus payments each quarter on the FR Y-9C, which is publicly available. What concerns, if any, are raised by making this reporting mandatory? What concerns, if any, are raised by making this reporting public as opposed to including this information in a confidential information collection?

Firms have significant outstanding amounts of alternative Tier 1 preferred stock capital. The terms of the preferred stock provide Firms with unfettered discretion to eliminate and cancel scheduled dividend payments.

Fixed income investors, rating agencies and other stakeholders and commentators express views and concerns as to the likelihood of scheduled non-cumulative dividend payments. This is all the more so during deteriorating market conditions.

The current capital rules and capital conservation buffer provide a significant amount of headroom to Firms to declare and pay scheduled fully discretionary dividend payments. The proposed SCB capital conservation buffer will significantly reduce the headroom.

The Board's proposal for Firms to report their eligible retained income and capital distributions and discretionary bonus payments each quarter on the FR Y-9C provides transparency. Transparency provides incremental certainty of scheduled payment to fixed income preferred stock investors. This will result in a more efficient and functioning market throughout the cycle. Firms will maintain and improve the reliability of market access and financial flexibility especially so during deteriorating market conditions.

Thank you for the opportunity to comment on the proposed amendments. For further clarification or discussion of these comments my details are as follows.

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